Association for Financial Markets in Europe

Consultation Response

CP20/14 Updating the Dual-regulated Firms Remuneration Code to Reflect CRD V

30 September 2020

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **CP20/14 UPDATING THE DUAL-REGULATED FIRMS REMUNERATION CODE TO REFLECT CRD V** (the "FCA CP"). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

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We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Executive Summary

We welcome the opportunity to comment on the FCA consultation paper on Updating the Dual-regulated Firms Remuneration Code to Reflect CRD V. Our comments to the FCA have been drafted to align with our comments to the PRA on its consultation paper CP12/20 on the transposition of CRD V ("PRA CP").[1]

Our key concern is that the approaches taken by the FCA and PRA should align (ideally expressed also in the same format) and, where possible, not go beyond what is required by CRD V. In particular, we request a single, clear approach to the categorisation of Material Risk Takers ("MRTs") and the application of deferral and clawback rules. Many of AFME's members are dual-regulated firms, meaning that inconsistencies between the two sets of requirements will cause unnecessary operational complexity as well as confusion for affected staff. In this respect, we suggest:

- A single set of MRT categories referenced by both the FCA and PRA;
- A single high earner threshold for both the FCA and PRA;
- A consistent approach to the 'Risk Manager' category; and
- A streamlined approach to clawback, with a 7-year term applied in most cases.

[1] https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v

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Furthermore, inconsistencies between the UK and EU approaches will also bring challenges for cross-border businesses, where staff may be assessed as MRTs against multiple sets of criteria. For this reason, alignment with EU Member States' interpretations of CRD V is preferable wherever possible.

Finally, we note the following other key points from our response:

- Clarity in relation to part-year MRTs, notable the retention of the 3-month minimum term;
- That the Remuneration Code for Dual-Regulated Firms should not be applied to IFPRU investment firms of CRD groups which will be subject to UK Investment Firm Prudential Regime (IFPR);
- Acknowledgement of the practical challenges of applying remuneration policies where groups hold a participating interest in any entity, but not control; and
- Clear guidance on currency thresholds, including the conversion of all Euro thresholds to suitable Sterling figures.

We remain available to discuss any of the points made in our response in further detail.

Questions

Q1: Do you agree with our proposals to amend our rules and guidance on material risk takers?

As an overall comment, we are extremely concerned by the complex categorisation of MRTs, both in relation to the CRD V rules and between the FCA and PRA approaches.

In applying remuneration rules, CRD V differentiates only between two categories: those MRTs who are members of the management body or senior management and those MRTs who are not. However, the PRA and FCA rules, particularly in relation to deferrals and clawback, variously distinguish MRTs according to the following criteria:

- For the FCA and PRA: individuals performing a PRA senior management function;
- For the FCA: individuals performing a FCA senior management function;
- For the PRA, individuals who do not perform a PRA senior management function but are a member of the management body or senior management;
- For the PRA: individuals who are 'higher paid' MRTs, for which Appendix 1 Annex A, paragraph 1.3 uses two defining criteria:
    - annual variable remuneration exceeds 33% of their total remuneration, and
    - total remuneration exceeds £500,000;
- For the FCA: individuals earning over £500,000 (i.e. a single criterion that is distinct from the PRA's 'higher-paid' category); and
- For the PRA: individuals who are 'higher paid' MRTs but who also meet certain qualitative criteria (this corresponds to the former concept of 'Risk Managers' although this term has not been retained).

The number of categories, as well as the lack of alignment between the FCA and PRA, will not only cause administrative complexity for firms, increasing the cost of compliance, but will also make it much more challenging to set out a clear and consistent remuneration policy for staff.

We strongly suggest that the FCA and PRA should align their approaches and produce a single set of categories for firms to reference across both sets of requirements, possibly set out in tabular form.[2] This should include:

[2] By way of example, we note Table A on page 8 of the joint policy statement PRA PS12/15 and FCA PS15/16 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2015/ps1215

- The FCA and PRA both referencing requirements for individuals performing (1) a PRA senior management function or (2) FCA senior management function, even where these requirements are different (currently the FCA CP references both, but the PRA CP only references PRA senior management functions);
- A consistent approach to 'higher-paid' individuals. In this respect, we suggest that the FCA's single criterion of total remuneration exceeding £500,000 is more in line with the current approach and should be retained, rather than the two criteria proposed by the PRA CP. Alternatively, we would strongly suggest consideration of alignment with the threshold set for at least 60% deferral in paragraph 5.44 of the current PRA SS2/17[3], i.e. total variable remuneration exceeding £500,000; and
- A consistent approach to the 'Risk Manager' category, which should also exclude the quantitative criteria set out in 3.1(c).

Furthermore, we note that many firms will be subject to EU Member State MRT identification requirements as well as those of the UK. From this perspective, consideration of the simplicity of the approach taken by CRD V is important, to reduce fragmentation between the UK and EU and the resulting possibility that individuals working for multiple entities may be subject to differing and overlapping MRT thresholds.

In relation to how the complexity of categories specifically affects deferrals and clawback, please see our responses to Q5 and Q6 below.

Q2: Do you agree with our proposed approach to proportionality and, in particular, with our proposed exemptions for certain firms and individuals?

We recognise that the changes to the thresholds for applying a proportionate approach for individuals reflect the requirements of CRD V and are therefore mandatory. However, these changes will bring more people into scope of deferral, retained shares, and the holding and retention periods for discretionary pension benefits; and we do not believe that this will substantially further the objectives of promoting effective risk management and discouraging excessive risk-taking (due to the low absolute value of variable pay used). Indeed, some of the individuals captured as Material Risk Takers (MRTs) may not be of significant seniority, for example if they are caught by virtue of their committee membership, and this could even discourage such individuals from taking on committee roles (despite the experience and exposure that can be gained). We would therefore welcome a further review of these thresholds once the EU Exit Transition Period ends.

Both the FCA CP (Part E) and the PRA CP (paragraph 3.18) propose an amendment to part year MRTs in line with CRD V restrictions on disapplication of rules at an individual level. For those employees who perform a role that would be typically designed as an MRT role for less than 3 months of a performance year, could the FCA confirm that they should not be identified as an MRT in the performance year in question? We note paragraph 89 of the EBA Guidelines on Sound Remuneration Policies ("EBA Guidelines") *"Institutions should ensure that staff that fall or are likely to fall under the criteria in Article 3 for a period of at least three months in a financial year are treated as identified staff"* which supports this interpretation.[4] Identification as an MRT for such a short period may disincentivise individuals from taking on such a role towards the end of a performance year. Additionally, in practice, the first couple of months of a new role are often also a period of adjustment, in which individuals may not yet have taken on full decision-making responsibility within the role. Those leaving a MRT role might also be affected, for example where there are handover periods or gardening leave.

[3] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2017/ss217.pdf?la=en&hash=71A98E5E2CDD629F9C219C09480AF1CED95E909E
[4] https://eba.europa.eu/regulation-and-policy/remuneration/guidelines-on-sound-remuneration-policies

Furthermore, we would appreciate clarity as to the arrangements for individuals travelling from overseas to work in the UK for a short-term assignment of less than 3 months. Currently, such individuals are not automatically subject to the MRT rules and we would request the continuation of this flexibility.

Q3: Do you agree with our proposed approach to the application of proportionality to third country branches in the UK?

AFME has no comments in response to this question.

Q4: Do you agree with our proposed approach to the application of remuneration rules to groups?

In addition to one point in relation to Q11 below concerning investment firms of CRD groups which will be subject to UK Investment Firm Prudential Regime (IFPR), we would like to raise the following concerns.

First, we disagree with the current approach whereby certain investment firms that are part of a broader financial group including credit institutions are treated as part of that broader financial group for the purposes of remuneration requirements. For example, the remuneration requirements for the investment firm may depend on the "proportionality level" of the credit institution, even where investment firm is not in the same prudential consolidation group as the credit institution. This extends the concept of "group" beyond the prudential consolidation group.

In our view, it does not make sense to continue to apply this approach under a new prudential regime for investment firms, as this unnecessarily maintains a link to CRD principles, which IFPR is meant to end.

Instead there should be alignment of groups for prudential purposes with groups for remuneration purposes. This means that investment firms in a prudential consolidation group that only consists of investment firms, should be able to apply the new investment firm remuneration code, and should not have to apply a dual-regulated remuneration code or any future CRD5 remuneration code.

We therefore disagree with the approach set out in paragraphs 4.45-4.47 of the FCA CP. Instead we support the alternative approach indicated in paragraph 4.48, whereby investment firms are permitted to apply the investment firms remuneration code at individual level and prudential consolidation level (unless they choose to apply CRD V across the group). The nexus to the wider financial group should not be applied.

Second, paragraph 4.45 of the FCA CP states *"Consistent with the PRA, we propose to maintain our current approach of applying remuneration requirements on a consolidated basis to firms within a group, as defined in section 421 FSMA"* (emphasis added). Our concern relates to applying remuneration requirements based on the FSMA section 421 definition, which would include any entities in which a group has a participating interest, which can be as low as 20%. This is not a level at which a group can exercise control over the entity.

Groups understand the need for a good corporate governance framework across subsidiaries that adheres to any local legal and regulatory requirements. However, there is not the same ability to control entities in which a group only has a participating interest. A group cannot mandate such entities to remunerate their employees in a way that is consistent with that group's deferral and clawback requirements, the bonus cap, rules relating to identification of MRTs and the application of a compliant remuneration policy to name some of the requirements.

By way of example, there are companies where multiple regulated firms may each have interests on or around 20%. If each such firm is subject to different regulatory requirements it will create practical difficulties in terms of how a single remuneration policy for such company can ensure the required level of compliance for each investor firm. Even where investor firms are subject to the same remuneration requirements, there can still be divergences between each firm's remuneration policies and application of the rules.

Therefore we would ask the FCA (and a similar request will be made in response to the PRA CP) to acknowledge the practical challenges in following the section 421 FSMA definition where groups hold a participating interest but not control.

Q5: Do you agree with our proposals for minimum deferral periods?

Further to our comments in Question 1 above on the categorisation of MRTs, we also note that there are differences between the proposed PRA and FCA remuneration rules for dual-regulated firms which creates unnecessary complexity for such firms and also increases operational administrative burden for firms.

We have set out below the differences we believe exist between the proposed PRA and FCA remuneration rules in relation to deferral periods:

a) Deferral period for PRA SMFs: For individuals earnings below £500,000 the proposed FCA rules prescribe a five-year deferral period, however, it appears the proposed PRA rules in PRA CP 15.17(1) prescribe a four-year deferral period.
b) Misalignment in deferral periods: The PRA rules propose a five-year deferral period for individuals that fall within the proposed Rule 15.17(2)(a). However, the proposed FCA rules for dual-regulated firms allows firms to apply a four-to-five-year deferral period.
c) Relaxation of deferral periods: the PRA has proposed that firms can apply lower deferral periods for MRTs whose total compensation is not more than £500,000 and variable pay is not more than 33% of total compensation. Whereas FCA proposes a lower deferral period for those with earnings not more than £500,000 (with no reference to the percentage of total compensation made up by variable pay).

We would highly recommend that the PRA and FCA align their remuneration rules for dual-regulated firms. In the absence of such clarity, our members are concerned that both the firms and the PRA/FCA will enter into debate as to the correct deferral periods for certain categories of individuals as part of each annual pay review round. This will increasing the administrative and operational burden for firms, as well as the adding difficulty in explaining the application of the rules to affected staff.

As CRD V now mandates a five-year deferral period for members of management body and senior management, we would ask that the PRA and FCA consider the following options to avoid fragmentation between the UK and EU:

a) Option 1: Completely align the deferral periods with the requirements under CRD V
    - Five-year deferral period for members of management and senior management (as proposed under the rules); and
    - Four-year deferral for all other MRTs

    This approach would align the UK rules with the CRD V rules. While it would represent a shortening of the deferral period for PRA SMFs, the clawback period would continue to apply for a minimum of 7 (and up to 10) years.

b) Option 2: Align the population subject to five-year and four-year deferral periods with the requirements under CRD V
    - Seven-year deferral for MRTs in PRA-designated senior management functions (PRA SMFs)
    - Five-year deferral period for members of management and senior management and MRTs in FCA designated senior management functions (as proposed under the rules)

- Four-year deferral for all other MRTs.

This approach would maintain the longer deferral period for PRA SMFs but align the deferral period for all other MRTs with the requirements in CRD V and also maintain alignment between the PRA and FCA rules for dual-regulated firms. It would also reduce inconsistency in the approach between UK and EU firms post the EU exit transition period.

c) Option 3: Ensure the five-year deferral period is not extended to individuals not previously captured under PRA rules and CRD V requirements

This approach would ensure the five-year deferral period is not extended to individuals who not subject to the five-year deferral under the current PRA remuneration rules and who are also not required to be subject to a five-year deferral period under CRD V.

Finally, it would be helpful if both the FCA and PRA could clarify whether they intend to retain the EBA Guidelines' (paragraph 267) approach to retention periods, namely 12 months for all employees, other than Risk Managers, who have a 6 month period.

Q6: Do you agree with our proposals for minimum clawback periods?

Please refer to our comments in Question 1 above on streamlining the overall approach to the categorisation of MRTs. We would then like to make the following comments specifically on the application of clawback.

Whilst we recognise the drivers for the proposed changes and the positive intent in reducing clawback periods for some MRTs, these will be operationally very difficult to manage as we expect colleagues may move between MRT categories and earning more or less than £500,000 year on year. This will lead to different clawback periods being applied to different awards; and potentially there being different treatment of the up-front portion of awards from one year to the next.

The current approach of applying 7 year clawback to all awards from the date of grant is simpler to manage, is easier for colleagues in scope of the remuneration rules to understand and, since instances of clawback are generally limited, does not have a negative proportionality impact. Given that a standardised clawback period for all MRTs is not inconsistent with the requirements of the EBA Guidelines, our preference would be to retain the current approach. If the FCA wishes to retain some element of proportionality, we suggest only two levels: 7 years, except for remuneration not subject to deferral, in which case the clawback period should be 1 year.

If the FCA wishes to retain the proposed tiered system, we would make the following comments in relation to the current drafting proposals:

- SYSC 19D.3.61 (3A)(c) applies to undeferred remuneration, yet refers to *"the sum of the deferral and retention period applied by the firm"*, which we suggest is amended.
- SYSC 19.D.3.61 (3A) (a&b) we note that use of "greater of" means that if firms choose to apply a longer deferral than the requirement, the clawback length also has to be lengthened accordingly. We suggest that this is amended, as it currently appears an unintended penalty for firms doing more than the rules require.

Q7: Do you agree with our proposal for a new rule and guidance on the gender neutrality of remuneration policies and practices?

We agree with the FCA's proposal to not add to existing Gender Pay Gap reporting & remuneration benchmarking. We note the reference to existing obligations to ensure that performance assessment, remuneration policies & practices do not discriminate on ground of protected characteristics.

Q8: Do you agree with our proposal to permit listed firms to award variable remuneration in the form of share-linked instruments and equivalent non-cash instruments?

AFME agrees with the proposal.

Q9: Do you agree that firms should apply the amended rules and guidance from the next performance year that begins on or after 29 December 2020?

AFME agrees with the proposal.

Q10: Do you agree with our proposal to leave our reporting requirements on remuneration unchanged?

AFME agrees with the proposal.

Q11: Do you agree with our proposal to create a separate version of the General Guidance with Frequently Asked Questions for IFPRU investment firms?

We suggest that the Remuneration Code for Dual-Regulated Firms should not be applied to investment firms of CRD groups which will be subject to UK Investment Firm Prudential Regime (IFPR). This is on the basis that standalone IFPR entities would not be subject to CRD rules but only to IFPR remuneration rules, which includes a 3-year deferral period (as opposed to a 4-year period under CRD V), and no bonus cap. Not allowing investment firms of banking groups to only apply the IFPR rules (and disapply the CRD V rules) would create challenges for them in terms of employee attraction and retention, as these entities compete against standalone investment firms for talent. Instead we propose that the PRA and FCA:

- only apply the Remuneration Code for Dual-Regulated firms to individuals of IFPR firms that have a material impact on the banking group's risk profile (i.e. who meet the qualitative MRT criteria for the banking group); and
- apply the IFPR Remuneration Code[5] to IFPR firm staff who meet only the quantitative remuneration criteria (which are the same under CRD and under the IFPR).

Q12: Do you agree with our proposals to address the deficiencies arising from the UK's exit from the EU?

AFME agrees with the proposal.

Q13: Do you agree with our proposals to convert from Euros to Sterling the proportionality thresholds and thresholds relevant to the identification of material risk takers?

Yes. This is a helpful amendment to provide consistency year on year by removing the impact of exchange rate fluctuations between Euros and Sterling. However, we would be grateful for clarification on the

[5] FCA Handbook SYSC 19A

frequency with which the FCA will review these thresholds, especially in the event of a material and sustained change in the prevailing exchange rate.

It may also make sense for thresholds such as £440,000 and £658,000 to be rounded (for example to £450,000 and £660,000) to make their neater figures for inclusion in remuneration policies.

In addition, guidance for non-UK firms as to how conversions to the new thresholds should be managed would be appreciated, in order to ensure a consistent approach across the industry. For example, whether specified exchange rate sources should be used.

Q14: Do you have any comments on our cost benefit analysis?

Given the complexity of approaches between the PRA and FCA outlined above, we suggest that the implementation cost for firms of the combined changes is likely to be significant. We have suggested above areas in which the proposals could be simplified, particularly in relation to the categorisation of MRTs and the application of clawback. If these are adopted, the cost to firms will be reduced.

Next steps

AFME welcomes the opportunity to submit comments, and would be pleased to engage further as the regulatory process continues.

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